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DEC 30 2005

**HOUSE OF REPRESENTATIVES**

December 30, 2005

Honorable Thomas J. Vilsack  
Governor  
State Capitol Building  
Des Moines, IA 50319

Dear Governor Vilsack:

Per Iowa Code 12E.15, the Tobacco Settlement Authority (the "TSA") is required to file an annual report regarding its activities for the previous fiscal year. I have enclosed the TSA's financial statements and an independent auditors' report for fiscal years ending June 30, 2004 and 2005.

Due to low interest rates and the re-emergence of the market for tobacco bonds, in July 2005 the TSA began analyzing the financial feasibility of restructuring and/or extending the final maturity of the Tobacco Settlement Authority Asset-Backed bonds. In August 2005 the TSA authorized the formation of a financing team to further consider the market opportunity. Through a competitive selection process the Treasurer selected Public Financial Management as financial advisor, Nixon Peabody and Dorsey & Whitney as transaction counsel and Citigroup and Bear Stearns as lead underwriters. Alternative structures were analyzed by the financing team and refined based on market conditions and legal considerations. Based on this analysis, a plan of finance was presented to the TSA board at the November 2005 board meeting. On November 9, 2005 the TSA adopted a resolution to proceed with a tobacco securitization based on a turbo amortization structure.

The Tobacco Settlement Authority Series 2005 Bonds priced on November 17, 2005 and closed on November 30, 2005. This issuance provided \$100.4 million in tax-exempt proceeds and \$50.1 million in taxable proceeds. The pledged Tobacco Settlement Revenues ("TSRs") remained at 78% with the remaining 22% continuing to flow into the Endowment for Iowans' Health Fund. The stated maturity of the bonds is 2046 with an expected maturity of 2028. The 2005 bonds have a turbo structure, which does not subject the pledged TSRs to trapping. As a result of this, approximately \$20 million in trapped TSRs were released from the Trapping Account. The structure that was utilized in this transaction provided the most effective opportunity to transfer additional tobacco industry risk and provide additional funds for deposit into the Healthy Iowans Tobacco Trust for appropriation by the General Assembly.

Respectfully submitted,

A handwritten signature in cursive script, reading "Michael L. Fitzgerald". The signature is written in dark ink and is positioned above the printed name and title.

Michael L. Fitzgerald  
Tobacco Settlement Authority, Chairperson

enc: Tobacco Settlement Authority basic financial statements

cc: Honorable Thomas Miller, Attorney General  
Senator John P. Kibbie, Democratic President of the Senate  
Senator Jeff Lamberti, Republican President of the Senate  
Representative Christopher Rants, Speaker of the House  
Senator Michael E. Gronstal, Democratic Floor Leader of the Senate  
Senator Stewart E. Iverson, Republican Floor Leader of the Senate  
Representative Chuck Gipp, Majority Leader of the House  
Representative Pat Murphy, Minority Leader of the House  
Mike Marshall, Secretary of the Senate  
Margaret Thomson, Chief Clerk of the House



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HOUSE OF REPRESENTATIVES

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Basic Financial Statements

June 30, 2005 and 2004

(With Independent Auditors' Report Thereon)

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

**Table of Contents**

	<b>Page</b>
Independent Auditors' Report	1
Management's Discussion and Analysis	3
Statements of Net Assets (Deficit)	7
Statements of Revenues, Expenses, and Changes in Net Assets (Deficit)	8
Statements of Cash Flows	9
Notes to Financial Statements	10
Independent Auditors' Report on Internal Control Over Financial Reporting and Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with <i>Government Auditing Standards</i>	21



KPMG LLP  
2500 Ruan Center  
666 Grand Avenue  
Des Moines, IA 50309

## Independent Auditors' Report

The Board  
Tobacco Settlement Authority:

We have audited the accompanying financial statements of the Tobacco Settlement Authority (the Authority), a component unit of the State of Iowa, as of and for the years ended June 30, 2005 and 2004, as listed in the table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express opinions on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Tobacco Settlement Authority as of June 30, 2005 and 2004, and the respective changes in financial position and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As described in note 1(c), the Authority adopted in 2005, the provisions of Governmental Accounting Standards Board Statement No. 40, *Deposits and Investment Risk Disclosures, an Amendment to GASB Statement No. 3*.

In accordance with *Government Auditing Standards*, we have also issued our report dated October 14, 2005 on our consideration of the Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The management's discussion and analysis on pages 3 through 6 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

October 14, 2005, except as to note 5,  
which is as of November 30, 2005

## **TOBACCO SETTLEMENT AUTHORITY**

(A Component Unit of the State of Iowa)

Management's Discussion and Analysis

Years ended June 30, 2005 and 2004

The Tobacco Settlement Authority (Authority) provides this management's discussion and analysis of the Authority's annual financial statements. This narrative overview and analysis of the financial activities of the Authority is for the fiscal years ended June 30, 2005 and 2004. We encourage readers to consider this information in conjunction with the Authority's basic financial statements, which follow this section.

### **Using These Financial Statements**

This discussion and analysis is intended to serve as an introduction to the Authority's basic financial statements, which consist of the statements of net assets (deficit), the statements of revenues, expenses, and changes in net assets (deficit), and the statements of cash flows (pages 7 through 9). These basic financial statements provide information about the activities of the Authority as a whole and include all assets and liabilities using the accrual basis of accounting, which is similar to the accounting used by most private-sector companies. They also include the notes to the financial statements, which explain some of the information in the basic financial statements in greater detail and are further described as follows:

#### ***The Statements of Net Assets (Deficit)***

The statements of net assets (deficit) present all of the Authority's assets and liabilities, with the differences between the two reported as "net assets (deficit)". Over time, increases or decreases in the Authority's net assets may serve as a useful indicator of whether the financial position of the Authority is improving or deteriorating.

#### ***The Statements of Revenues, Expenses, and Changes in Net Assets (Deficit)***

The statements of revenues, expenses, and changes in net assets (deficit) present information showing how the Authority's net assets (deficit) changed during the most recent fiscal year. All changes in net assets (deficit) are reported as soon as the event or change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in these statements for some items that will not result in cash flows until future fiscal periods.

#### ***The Statements of Cash Flows***

The statements of cash flows report the net increase (or decrease) in cash and cash equivalents (highly liquid investments with a maturity of three months or less when purchased) for the fiscal year. These statements include cash flows from operating activities, cash flows from non-capital financing activities (such as issuance of or payments on bonds), and cash flows from investing activities. The resulting net increase (or decrease) in cash and cash equivalents is then added to the balance of cash and cash equivalents at the beginning of the year to determine the FY05 and FY04 ending cash and cash equivalents balance.

#### ***Notes to the Financial Statements***

The notes provide additional information that is essential to a full understanding of the data provided in the basic financial statements. The notes to the financial statements can be found beginning on page 10.

## **TOBACCO SETTLEMENT AUTHORITY**

(A Component Unit of the State of Iowa)

### **Management's Discussion and Analysis**

Years ended June 30, 2005 and 2004

#### **Financial Analysis of the Authority**

The principal activity of the Authority was the sale of approximately \$644 million of bonds at a discount, providing approximately \$630 million of proceeds and the initial distribution of approximately \$579 million of the proceeds to the State of Iowa (State), after providing for payment of issuance costs and establishment of reserve funds required by the bond resolutions. In return for distribution to the State, the Authority will receive 78% of the payments the State is entitled to under the Master Settlement Agreement signed in 1998 between 46 states and the four major tobacco industry manufacturers to be used to repay the bonds issued.

The Authority's financial activity resulted in negative net assets of approximately \$525 million and \$535 million at June 30, 2005 and 2004, respectively. The negative net assets result from the Authority recording a liability, in accordance with accounting principles generally accepted in the United States of America, for the entire amount of outstanding bonds, which are payable only from proceeds from the Master Settlement Agreement, while being precluded by those same principles from recording anticipated receipt of those proceeds. However, by purchasing the bonds, the buyers of the Authority's bonds demonstrated their belief that those proceeds will be realized by the Authority and will be used to repay the bonds. If the Authority does not realize sufficient proceeds, not all bonds will be repaid.



**TOBACCO SETTLEMENT AUTHORITY**

(A Component Unit of the State of Iowa)

**Management's Discussion and Analysis**

Years ended June 30, 2005 and 2004

Condensed financial information as of and for the years ended June 30, 2005, 2004, and 2003 is as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Assets:			
Current assets	\$ 18,281,718	17,496,384	21,370,201
Noncurrent assets	87,545,798	78,724,440	70,723,052
Total assets	<u>105,827,516</u>	<u>96,220,824</u>	<u>92,093,253</u>
Current liabilities	4,231,854	3,681,294	3,328,305
Noncurrent liabilities	626,689,120	627,899,434	628,547,359
Total liabilities	<u>630,920,974</u>	<u>631,580,728</u>	<u>631,875,664</u>
Net assets (deficit)	<u>\$ (525,093,458)</u>	<u>(535,359,904)</u>	<u>(539,782,411)</u>
Operating revenues:			
Tobacco settlement revenues	\$ 44,011,224	38,642,388	53,508,749
Operating expenses:			
Distributions to the State of Iowa	—	—	23,959,250
Operating expenses	54,181	106,656	104,865
Enforcement expenses	315,433	305,535	—
Total operating expenses	<u>369,614</u>	<u>412,191</u>	<u>24,064,115</u>
Operating income	43,641,610	38,230,197	29,444,634
Nonoperating expenses, net	<u>(33,375,164)</u>	<u>(33,807,690)</u>	<u>(33,764,701)</u>
Change in net assets (deficit)	10,266,446	4,422,507	(4,320,067)
Net assets (deficit) beginning of year	<u>(535,359,904)</u>	<u>(539,782,411)</u>	<u>(535,462,344)</u>
Net assets (deficit) end of year	<u>\$ (525,093,458)</u>	<u>(535,359,904)</u>	<u>(539,782,411)</u>

***Net Assets***

The Authority's net assets increased approximately \$10.3 million during fiscal year 2005 due to the following:

- (a) Cash and investments increased \$8.8 million due largely to the Authority holding tobacco settlement collections in the Trapping Account as required by the bond indenture. In addition, higher balances also generated more interest income that increased net assets.
- (b) Liabilities of the Authority decreased slightly because of principal bond payments.

## **TOBACCO SETTLEMENT AUTHORITY**

(A Component Unit of the State of Iowa)

### **Management's Discussion and Analysis**

Years ended June 30, 2005 and 2004

The Authority's net assets increased approximately \$4.4 million during fiscal year 2004 due to the following:

- (a) Tobacco settlement collections decreased approximately \$15 million during the year. The MSA sets forth the schedule and calculation of payments to be made by the tobacco industry manufacturers to the states. However, these payments are subject to various adjustments and offsets, some of which could be material.

In addition, due to the implementation of Governmental Accounting Standards Board (GASB) Technical Bulletin 2004-1, a receivable was recorded for estimated MSA payments. The estimated receivable for June 30, 2004 is approximately \$4.3 million less than the balance at June 30, 2003.

- (b) The Authority did not distribute any excess tobacco settlement collections to the State of Iowa during the year ended June 30, 2004, whereas approximately \$24 million was distributed during the year ended June 30, 2003. In June 2003, there was a significant downgrade in the Moody/S&P rating of one of the tobacco industry manufacturers participating in the MSA. As a result, the indenture trustee established an additional account, the Trapping Account, into which pledged MSA payments were deposited. As a result, no funds were available for transfer to the State.
- (c) Cash and investments increased approximately \$8 million due to the Authority holding tobacco settlement collections in the Trapping Account at June 30, 2004, as required by the bond indenture.

#### ***Long-Term Debt***

At June 30, 2005 and 2004, the Authority had \$639,460,000 and \$640,950,000, respectively, in tobacco settlement asset-backed bonds outstanding. More detailed information about the Authority's debt is presented in note 3 to the financial statements.

#### ***Known Facts***

During June 2003, there was a significant downgrade in the Moody/S&P rating of one of the tobacco manufacturers participating in the MSA. As a result, the indenture trustee established an additional reserve account, the trapping account, into which pledged MSA payments (that otherwise would have been released from the lien of the bond indenture) will be deposited to the extent required by the bond indenture.

#### **Contacting the Tobacco Settlement Authority Financial Management**

This financial report is designed to present users with a general overview of the Authority's finances and to demonstrate the Authority's accountability for the funds generated. If you have any questions about the report or need additional financial information, please contact the Office of the State Treasurer, State Capitol Building, Des Moines, IA 50319.

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Statements of Net Assets (Deficit)

Years ended June 30, 2005 and 2004

Assets	2005	2004
Current assets:		
Cash on deposit with Treasurer of State	\$ 167,472	259,173
Accounts receivable	188,953	60,337
Master settlement agreement receivable	17,392,469	16,802,110
Interest receivable	465,637	307,577
Deferred charges	67,187	67,187
Total current assets	18,281,718	17,496,384
Noncurrent assets:		
Restricted assets:		
Cash and cash equivalents	66,745	1,407,072
Investments	86,113,286	75,884,414
Deferred charges	1,365,767	1,432,954
Total assets	105,827,516	96,220,824
<b>Liabilities</b>		
Current liabilities:		
Accounts payable	189,263	193,032
Bonds payable, current portion	1,210,314	647,925
Accrued interest payable	2,832,277	2,840,337
Total current liabilities	4,231,854	3,681,294
Noncurrent liabilities:		
Bonds payable, net of current portion	626,689,120	627,899,434
Total liabilities	630,920,974	631,580,728
Net assets (deficit)	\$ (525,093,458)	(535,359,904)

See accompanying notes to financial statements.

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Statements of Revenues, Expenses, and Changes in Net Assets (Deficit)

Years ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Operating revenues:		
Tobacco settlement revenues	\$ 44,011,224	38,642,388
Operating expenses:		
Operating expenses	54,181	106,656
Enforcement expenses	315,433	305,535
Total operating expenses	<u>369,614</u>	<u>412,191</u>
Operating income	<u>43,641,610</u>	<u>38,230,197</u>
Nonoperating revenues (expenses):		
Interest income	3,177,167	2,837,626
Amortization of bond issuance costs	(67,187)	(67,187)
Interest expense	<u>(36,485,144)</u>	<u>(36,578,129)</u>
Total nonoperating expenses, net	<u>(33,375,164)</u>	<u>(33,807,690)</u>
Change in net assets (deficit)	10,266,446	4,422,507
Net assets (deficit) beginning of year	<u>(535,359,904)</u>	<u>(539,782,411)</u>
Net assets (deficit) end of year	<u><u>\$ (525,093,458)</u></u>	<u><u>(535,359,904)</u></u>

See accompanying notes to financial statements.

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Statements of Cash Flows

Years ended June 30, 2005 and 2004

	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:		
Cash received from tobacco settlement agreement	\$ 43,292,249	42,863,604
Cash payments to suppliers	(373,383)	(219,158)
Net cash provided by operating activities	<u>42,918,866</u>	<u>42,644,446</u>
Cash flows from noncapital financing activities:		
Principal payment on bonds	(1,490,000)	(1,325,000)
Payment of interest on bonds	(35,651,129)	(35,741,097)
Net cash used in noncapital financing activities	<u>(37,141,129)</u>	<u>(37,066,097)</u>
Cash flows from investing activities:		
Purchases of investments	(186,055,309)	(132,590,907)
Sale/maturities of investments	175,826,437	104,841,854
Interest received on investments	3,019,107	2,749,400
Net cash used in investing activities	<u>(7,209,765)</u>	<u>(24,999,653)</u>
Decrease in cash and cash equivalents	(1,432,028)	(19,421,304)
Cash and cash equivalents, beginning of year	<u>1,666,245</u>	<u>21,087,549</u>
Cash and cash equivalents, end of year	<u>\$ 234,217</u>	<u>1,666,245</u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income	\$ 43,641,610	38,230,197
Adjustments to reconcile operating income to net cash provided by operating activities:		
(Increase) decrease in receivables	(718,975)	4,221,217
(Decrease) increase in payables	(3,769)	193,032
Net cash provided by operating activities	<u>\$ 42,918,866</u>	<u>42,644,446</u>

See accompanying notes to financial statements.

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Notes to Financial Statements

Years ended June 30, 2005 and 2004

**(1) Summary of Significant Accounting Policies and Related Matters**

**(a) Organization**

The Tobacco Settlement Authority (the Authority) was authorized by the provisions of Chapter 12E of the Code of Iowa on May 19, 2000. The purposes of the Authority include: (a) to implement and administer a program plan and to establish a stable source of revenue to be used for purposes designated in Chapter 12.65 of the Code of Iowa, (b) to enter into sales agreements, (c) to issue bonds and enter into funding options including refunding and refinancing its debt and obligations, (d) to sell, pledge, or assign, as security, all or a portion of the State's share, to provide for and secure the issuance of its bonds, (e) to invest funds available to provide for a source of revenue in accordance with the program plan, (f) to enter into agreements with the State for the periodic distribution of amounts due the State under any sales agreement, (g) to refund and refinance the Authority's debts and obligations, and to manage its funds, obligations, and investments as necessary, (h) to sell, pledge, or assign, as security or consideration, all or a portion of the State's share to implement alternative funding options, and (i) to implement the purposes of Chapter 12E of the Code of Iowa.

**(b) Reporting Entity**

The Authority is a component unit of the State of Iowa (State). The financial statements of the Authority are included in the State's comprehensive annual financial report.

For financial reporting purposes, the Authority has included all funds, organizations, agencies, boards, commissions, and authorities. The Authority has also considered all potential component units for which it is financially accountable, and other organizations for which the nature and significance of their relationship with the Authority are such that exclusion would cause the Authority's financial statements to be misleading or incomplete. The Governmental Accounting Standards Board (GASB) has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body, and (1) the ability of the Authority to impose its will on that organization or (2) the potential for the organization to provide specific benefits to, or impose specific financial burdens on the Authority. The Authority has no component units which meet the GASB criteria.

**(c) Measurement Focus, Basis of Accounting, and Financial Statement Presentation**

The Authority is accounted for using the economic resources measurement focus and the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

In reporting the financial activity of the Authority, the Authority applies all applicable GASB pronouncements as well as the following pronouncements issued on or before November 30, 1989 unless these pronouncements conflict with or contradict GASB pronouncements: Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins of the Committee on Accounting Procedure.

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Notes to Financial Statements

Years ended June 30, 2005 and 2004

For financial statement purposes, the Authority is treated as an enterprise fund, a proprietary fund type. Proprietary funds distinguish operating revenues and expenses from nonoperating items. Operating revenues and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations, which includes the monetization of the State's future tobacco settlement payments. All revenues and expenses not meeting this definition are reported as nonoperating revenues and expenses.

In 2005, the Authority implemented GASB Statement No. 40, *Deposit and Investment Risk Disclosures, an Amendment of GASB Statement No. 3*. GASB Statement No. 40 addresses disclosures on deposits and investments, focusing on common investment risks related to interest rate risk, credit risk, custodial credit risk, foreign currency risk, and concentration of credit risk. This pronouncement requires additional disclosures to be presented in the notes but has no impact on the net assets of the Authority.

The Authority's board consists of the Treasurer of State, Auditor of State, and the Director of the Department of Management of the State.

**(d) Master Settlement Agreement**

On November 23, 1998, a Master Settlement Agreement (MSA) was entered into between forty-six states (including the state of Iowa) and the four major tobacco industry manufacturers. The MSA represents the resolution of a large potential financial liability of the tobacco industry manufacturers for smoking-related injuries. The forty-six states agreed to settle all past, present, and future smoking-related claims against the tobacco industry manufacturers in exchange for agreements and undertakings by the tobacco industry manufacturers concerning a number of issues.

The MSA sets forth the schedule and calculation of payments to be made by the tobacco industry manufacturers to the states. These payments are subject to various adjustments and offsets. Payments to be received under the MSA include:

- a. five initial payments, the last of which was paid in January 2003;
- b. annual payments which are required to be made on April 15 of each year and will continue in perpetuity; and
- c. ten strategic contribution fund payments which are required to be made annually on April 15 beginning April 15, 2008 through April 15, 2017.

**(e) Program Plan**

Chapter 12E.10 of the Code of Iowa directs the Authority to establish a Tobacco Settlement Program Plan (Program Plan) to provide the State with a secure and stable source of revenue for the purposes designated in Chapter 12.65 of the Code of Iowa. These purposes relate to healthcare, substance abuse treatment and enforcement, tobacco use prevention and control, and other purposes related to the needs of children, adults, and families in the State and to create a savings account for healthy Iowans invested to provide an ongoing source of investment earnings.

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Notes to Financial Statements

Years ended June 30, 2005 and 2004

The Program Plan was submitted to the Legislative and Executive Council of the State. Implementation of the Program Plan was authorized by a constitutional majority of each house of the General Assembly and approved by the Governor of the State.

**(f) Sales Agreement**

Upon approval of the Program Plan, the State and the Authority entered into a sales agreement in which the State agreed to sell to the Authority all of its right, title, and interest in certain amounts payable to the State under the MSA. In return, the Authority agreed to issue tobacco settlement bonds and remit the net bond proceeds to the State.

**(g) Tobacco Settlement Asset-Backed Bonds, Series 2001**

The Authority issued Tobacco Settlement Asset-Backed Bonds, Series 2001 (Series 2001 Bonds), dated October 25, 2001, in the amount of \$644,245,000. The Series 2001 Bonds are special revenue obligations of the Authority secured by, and payable solely and only out of, the monies, assets, or revenues pledged by the Authority pursuant to the indenture, are not a general obligation or general indebtedness of the Authority, and do not constitute an obligation or indebtedness of the State or any political subdivision of the State.

**(h) Significant Accounting Policies**

The financial statements of the Authority have been prepared in conformity with accounting principles generally accepted in the United States of America as applied to governmental units. The more significant of the Authority's accounting policies are described below.

**Cash Equivalents**

For purposes of the statements of cash flows, all highly liquid investments with a maturity of three months or less when purchased are considered to be cash equivalents. Investments not meeting the definition of cash equivalents at June 30, 2005 include U.S. Government securities and corporate notes totaling \$86,113,286 and at June 30, 2004 U.S. Governmental securities and a corporate note totaling \$75,884,414.

**Investments**

Investments in debt and equity securities are recorded at fair value in the statements of net assets (deficit) with the change in fair value of investments recorded in the statements of revenues, expenses, and changes in net assets (deficit).

**Deferred Charges**

Deferred charges represent bond issuance costs which are deferred and amortized as an adjustment to interest expense over the life of the related bond issue using the straight-line method.

**Bond Discounts**

Bond discounts are deferred and amortized as an adjustment to interest expense over the life of the related bond issue using the effective interest method.



**TOBACCO SETTLEMENT AUTHORITY**

(A Component Unit of the State of Iowa)

## Notes to Financial Statements

Years ended June 30, 2005 and 2004

**Revenue Recognition**

Future tobacco settlement collections are contingent upon future tobacco products sales subject to various adjustments as outlined in the MSA. The Authority recognizes revenue from tobacco settlement collections as the collections are received by the Authority. In addition, an estimated receivable (Master Settlement Agreement receivable) is accrued at year-end for estimated product sales occurring from January 1 through June 30 of each year.

**Use of Estimates**

Management of the Authority has made a number of estimates and assumptions relating to the reporting of assets, liabilities, revenues, and expenses and the disclosure of contingent assets or liabilities to prepare these financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ from those estimates.

**(2) Cash, Cash Equivalents, and Investments**

At June 30, 2005 and 2004, the Authority's bank balances of \$302 and \$2,658, respectively, were covered by federal depository insurance. Cash balances of \$167,472 and \$259,173, respectively, were held by the State in pooled money funds. Cash equivalents at June 30, 2005 and 2004 included \$66,443 and \$1,404,414, respectively, invested in open-end mutual funds.

Investments are as follows for the year ended June 30, 2005:

Investment Type	Fair value	Investment Maturities (in years)			Concentration
		Less than 1	1-2	3-5	
Debt securities:					
Britannia Bldg Society	\$ 2,074,820	2,074,820	—	—	2%
Federal Home Ln Mtg Corp	18,866,080	18,866,080	—	—	22
General Elec CAP Svc	48,135,134	48,135,134	—	—	56
McCormick & Co Inc.	15,698,240	15,698,240	—	—	18
North Sea Fdg Europe	1,339,012	1,339,012	—	—	2
	<u>\$ 86,113,286</u>	<u>86,113,286</u>	<u>—</u>	<u>—</u>	<u>100%</u>

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Notes to Financial Statements

Years ended June 30, 2005 and 2004

Investments are as follows for the year ended June 30, 2004:

Investment Type	Fair value	Investment Maturities (in years)			Concentration
		Less than 1	1-2	3-5	
Debt securities:					
Federal Home Ln Mtg Corp	\$ 9,857,569	9,857,569	—	—	13%
Federal Natl Mtg Assn	17,891,710	17,891,710	—	—	24
San Paolo Imi	48,135,135	48,135,135	—	—	63
	<u>\$ 75,884,414</u>	<u>75,884,414</u>	<u>—</u>	<u>—</u>	<u>100%</u>

*Interest Rate Risk:* The Authority does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from increasing interest rates.

*Credit Risk:* Under bond resolutions of the Official Statement of the Tobacco Settlement Asset-Backed Bonds, Series 2001, the Authority is authorized to invest in defeasance collateral; noncallable senior debt obligations of U.S. government-sponsored agencies that are not backed by the full faith and credit of the U.S. government; demand and time deposits in or certificates of, or banker's acceptances issued by, any bank or trust company, savings and loan association or savings bank; municipal obligations of any state of the United States or the State or any political subdivision thereof; commercial or finance company paper; repurchase obligations; securities bearing interest or sold at a discount issued by any corporation incorporated under the laws of the United States or any state, municipality or political subdivision thereof; units of taxable money market funds; investment agreements, forward delivery agreements, or guaranteed investment contracts rated, or with any financial institution or corporation; other obligations, securities, agreements or contracts that are noncallable and are acceptable to each nationally recognized rating service agency.

As of June 30, 2005 the Authority's investment in Britannia Bldg. Society and McCormick & Co Inc. commercial paper were rated A1 by Standard & Poor's and P-1 by Moody's Investors Service. The Authority's investment in North Sea Fdg Europe and General Elec Cap Corp, commercial paper were rated A1+ by Standard & Poor's and P-1 by Moody's Investors Service. The Authority's investment in Federal Home Loan Mtg. Corp was rated AAA by Standard & Poor's and Aaa by Moody's Investors Service.

*Concentration of Credit Risk:* The Authority places no limit on the amount that may be invested in any one issuer. Concentration percentages by investment type are included in the above table.

*Custodial Credit Risk:* The Authority's deposits in financial institutions were covered by the Federal Deposit Insurance Corporation, or collateral held by the Treasurer of State's custodial banks in the Treasurer of State's name, or by the bank assessment provisions of Section 12C23 of the Code of Iowa.

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Notes to Financial Statements

Years ended June 30, 2005 and 2004

**(3) Bonds Payable**

The Tobacco Settlement Asset-Backed Bonds were issued in two series: the Series 2001 A Bonds in the principal amount of \$40,000,000, which are federally taxable, and the Series 2001 B Bonds in the principal amount of \$604,245,000, which are federally tax-exempt.

The bonds bear interest at rates ranging from 5.30% to 6.79% and mature in varying annual amounts ranging from \$2,050,000 to \$71,340,000 with the final (Super Sinker Redemption) maturities due in the year ending June 30, 2027. The balance outstanding on June 30, 2005 and 2004 was \$627,899,434 (\$639,460,000 net of unamortized bond discount of \$11,560,566) and \$628,547,359 (\$640,950,000 net of unamortized bond discount of \$12,402,641), respectively.

The bond documents include the following provisions:

- (a) The Series 2001 Bonds are special revenue obligations of the Authority secured by, and payable solely and only out of, the monies, assets, or revenues pledged by the Authority pursuant to the Indenture. The bonds are not a general obligation or general indebtedness of the Authority, and do not constitute an obligation or indebtedness of the State or any political subdivision of the State. The Authority may not pledge the credit or taxing power of the State or any political subdivision of the State, or create a debt or obligation of the State. The Authority has no taxing power. The Series 2001 Bonds constitute neither a general, legal, or moral obligation of the State or any of its political subdivisions and the State has no obligation or intention to satisfy any deficiency or default of any payment of the bonds.
- (b) The bonds are secured by and are payable solely from (i) 78% of the future amounts to be received under the MSA, (ii) investment earnings on certain accounts pledged under the bond indenture, (iii) amounts held in the debt service reserve account and the trapping account established under the bond indenture, (iv) amounts held in other accounts established under the bond indenture, and (v) certain rights of the Authority as specified in the sales agreement.
- (c) The proceeds of the Series 2001 Bonds, except as deposited in the debt service reserve account, are not pledged to the payment of, and therefore not available to, the holders of the Series 2001 bonds.
- (d) A bond fund is established with the bond indenture trustee and money will be deposited in the fund as provided in the bond indenture. The money will be held in trust and, except as otherwise provided in the bond indenture, will be applied solely to the payment of debt service. The bond fund includes: the debt service account, the debt service reserve account, the trapping account, the extraordinary prepayment account, and such other accounts as deemed necessary.
- (e) The debt service reserve account was funded from bond proceeds in the amount of \$48,135,624. The account will be available to pay (i) the principal and interest on the bonds to the extent that collections under the MSA are insufficient and (ii) after an event of default, extraordinary prepayments. Upon the occurrence of an event of default, the outstanding bonds will be prepaid pro-rata among all outstanding bonds, and other unpaid amounts due on the bonds will be paid from available funds.

## **TOBACCO SETTLEMENT AUTHORITY**

(A Component Unit of the State of Iowa)

### **Notes to Financial Statements**

**Years ended June 30, 2005 and 2004**

- (f) An additional reserve account, the trapping account, is to be established and held by the Indenture Trustee and funded to the trapping requirement during the existence of a trapping event. A trapping event occurs in any calendar year preceding a deposit date when: (i) the shipment of cigarettes in or around the 50 states is less than the amount as measured under the MSA, (ii) there is a significant downgrade in the Moody or S&P rating of one of the tobacco manufacturers participating in the MSA, or (iii) the market share of one of the tobacco manufacturers who are not participating in the MSA exceeds 7%. Following the occurrence of a trapping event, pledged MSA payments that otherwise would have been released from the lien of the bond indenture will be deposited in the trapping account to the extent required by the bond indenture and will be available to pay interest, extraordinary prepayments, principal, and Super Sinker Redemptions.
- (g) If an event of default has occurred, collections remaining after the payment of certain expenses and all current and past due interest on bonds will be deposited in the extraordinary prepayment account and will be applied, together with amounts in the trapping account and the debt service reserve account, to extraordinary prepayments of the bonds on each succeeding distribution date.

**TOBACCO SETTLEMENT AUTHORITY BONDS**  
(A Component Unit of the State of Iowa)

Notes to Financial Statements  
Years ending June 30, 2005 and 2004

Series 2001 B Term Bonds(1)			Series 2001 B Term Bonds(1)			Total	
SSR	Int. Rate	Interest	SSR	Int. Rate	Interest	SSR/Principal	Interest
\$ —	—	\$ 10,910,050	—	—	\$ 18,876,760	2,050,000	35,549,959
—	—	10,910,050	—	—	18,876,760	3,285,000	35,410,763
—	—	10,910,050	—	—	18,876,760	17,315,000	35,187,712
8,410,000	5.30%	10,910,050	—	—	18,876,760	20,975,000	34,012,024
23,440,000	5.30%	10,464,320	—	—	18,876,760	23,440,000	32,713,130
53,705,000	5.30%	33,076,240	—	—	75,507,040	115,015,000	117,151,730
120,295,000	5.30%	13,937,940	18,680,000	5.60%	94,383,800	138,975,000	108,321,740
—	—	—	163,740,000	5.60%	72,028,600	163,740,000	72,028,600
—	—	—	154,665,000	5.60%	19,066,600	154,665,000	19,066,600
<u>\$ 205,850,000</u>		<u>\$ 101,118,700</u>	<u>337,085,000</u>		<u>\$ 355,369,840</u>	<u>639,460,000</u>	<u>489,442,258</u>

**TOBACCO SETTLEMENT AUTHORITY**  
(A Component Unit of the State of Iowa)

Notes to Financial Statements

Years ended June 30, 2005 and 2004

- (1) The "Super Sinker Redemption" of the term bonds represents the amount that the Authority has agreed to pay, to the extent of available collections. The debt service reserve account will not be available to make Super Sinker Redemption payments. To the extent that Super Sinker Redemption payments are made, they will be credited against the respective rated maturities. Failure to make a Super Sinker Redemption payment will not constitute an event of default.

If the Authority is able to make payments on the term bonds in accordance with the schedules of Super Sinker Redemptions, the average life of the term bonds will be significantly shorter than if paid on their respective maturity dates. If the Authority is unable to make payments on term bonds in accordance with the schedule of Super Sinker Redemptions, the term bonds remain outstanding until their respective maturity dates without triggering an event of default.

The rated maturity amounts and maturity dates are as follows:

	<u><b>Rated maturity amount</b></u>	<u><b>Maturity date</b></u>
Series 2001 A Term Bonds	\$ 40,000,000	June 1, 2010
Series 2001 B Term Bonds	205,850,000	June 1, 2025
Series 2001 B Term Bonds	337,085,000	June 1, 2035

To avoid triggering an event of default, at least \$40,000,000 must be paid by June 1, 2010, an additional \$205,850,000 by June 1, 2025, and an additional \$337,085,000 by June 1, 2035.

- (2) The "Serial Maturities" of the Series 2001 bond must be paid on the stated maturity date in order to avoid an event of default.

The following summarizes the bond payable activity for the Authority for the years ended June 30, 2005 and 2004:

	<u><b>2005</b></u>	<u><b>2004</b></u>
Bonds payable, net of bond discount beginning of year	\$ 628,547,359	629,028,159
Principal payment on bonds	(1,490,000)	(1,325,000)
Accretion of bond discount	842,075	844,200
Bonds payable, net of bond discount end of year	<u>\$ 627,899,434</u>	<u>628,547,359</u>

**(4) Deficit Net Asset Balance**

The payments to be received under the MSA represent a share of anticipated future sales of tobacco products. Although the Authority expects to receive certain amounts under the MSA, the collections are not assured.

# **TOBACCO SETTLEMENT AUTHORITY**

(A Component Unit of the State of Iowa)

Notes to Financial Statements

Years ended June 30, 2005 and 2004

Under accounting principles generally accepted in the United States of America, such contingent amounts cannot be recognized as a receivable or revenue. Accordingly, the Authority is reporting a restricted net asset (deficit) balance of \$(525,093,458) and \$(535,359,904) at June 30, 2005 and 2004, respectively.

## **(5) Subsequent Event**

On November 30, 2005, the Authority issued \$832 million of Series 2005 tobacco settlement asset-backed bonds to (a) refund the Series 2001 Bonds, (b) to provide additional funds to, or for the benefit of, the State, (c) to fund the debt service reserve account, and (d) to pay the costs of issuance of the Series 2005 Bonds.



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**Independent Auditors' Report on Internal Control Over Financial Reporting and on  
Compliance and Other Matters Based on an Audit of Financial Statements  
Performed in Accordance With *Government Auditing Standards***

The Board  
Tobacco Settlement Authority:

We have audited the financial statements of the Tobacco Settlement Authority, a component unit of the State of Iowa, as of and for the year ended June 30, 2005, and have issued our report thereon dated October 14, 2005, except as to note 5, which is as of November 30, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America, Chapter 11 of the Code of Iowa, and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

**Internal Control Over Financial Reporting**

In planning and performing our audit, we considered the Tobacco Settlement Authority, a component unit of the State of Iowa, internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Tobacco Settlement Authority, a component unit of the State of Iowa, financial statements are free of material misstatements, we performed tests of its compliance with certain provisions of laws, regulations, contracts, grants, and other matters, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of management of the Tobacco Settlement Authority, a component unit of the State of Iowa, and is not intended to be and should not be used by anyone other than these specified parties.

**KPMG LLP**

October 14, 2005, except as to note 5,  
which is as of November 30, 2005